

KENTUCKY COMPETES

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The Tax Reform Proposal by Governor Steve Beshear

A Presentation to House Appropriations and Revenue
February 11, 2014
Lt. Governor Jerry Abramson

Broaden the Base, Lower the Rates

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Recommendation from
12 Prior Tax Reform Studies &
the Blue Ribbon Commission

5 Guiding Principles of Tax Reform

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- Fairness
- Competitiveness
- Simplicity and Compliance
- Elasticity
- Adequacy

The Goals of Kentucky Competes

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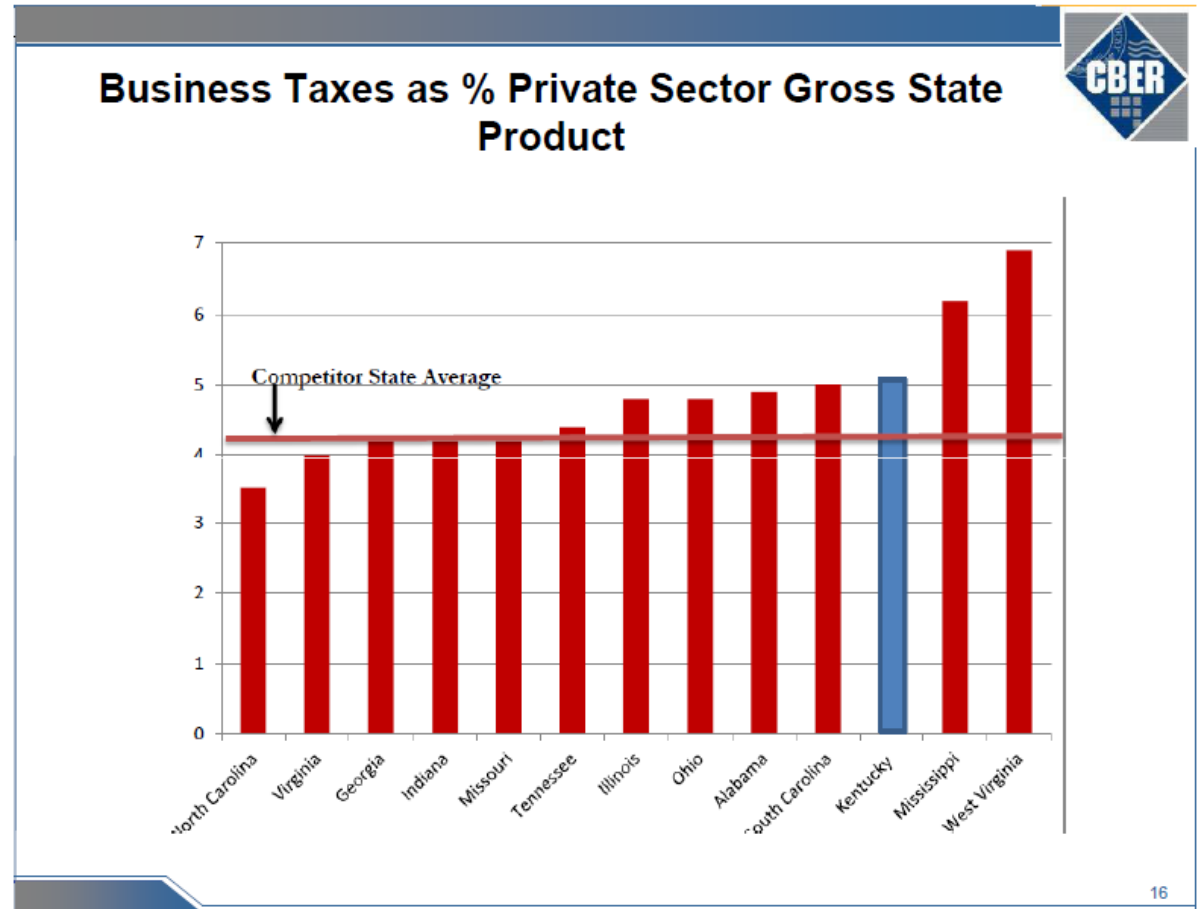
- 1) Create a Tax Code that Competes for Quality Jobs
- 2) Help Kentucky's Signature Industries Thrive and Expand
- 3) Create a Healthier Kentucky Workforce to Attract Jobs
- 4) Modernize Code to Acknowledge Changes in the Economy & Technology
- 5) Modernize Code to Acknowledge Changes in Competitor States

**1) Create a Tax Code that
Competes for Quality Jobs**

Need to Improve Competitiveness

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- According to the consultants to the Blue Ribbon Commission, for FY11, the average competitor state had business taxes equal to 4.2% of gross state product.
- In Kentucky, it was 5.5%, ranking 3rd highest behind Mississippi and West Virginia.



Need to Improve Competitiveness

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- Area Development magazine Fall 2012 named the top states for doing business. Kentucky did not make the top ten, but **seven of the top ten were states that Kentucky's Cabinet for Economic Development considers "competitor states."**
- In 2012, CNBC, with input from business groups including the National Association of Manufacturers and the Council on Competitiveness, ranked all 50 states on 51 measures of competitiveness. While Kentucky did well in a couple of categories – 1st in Cost of Business and 4th in Cost of Living – **overall Kentucky ranked 36th.** However, three of Kentucky's competitor states made the top ten.
- Forbes has released their 2013 best states for businesses and careers. **Kentucky ranks 26th, while three of our competitor states rank in the top ten.** In particular, we rank 45th for our Labor Supply.

Reduce Individual Income Tax Rates

- Reduces the top rate from 6% to 5.9%
- Reduces the number of tax brackets from six to four
 - Old rate brackets were in effect since 1960
 - Small change in 2005, but virtually unchanged since inception
- Along with the proposed EITC and KY's existing Family Size Tax credit, this plan includes a hold harmless provision to ensure no taxpayers see rate increases

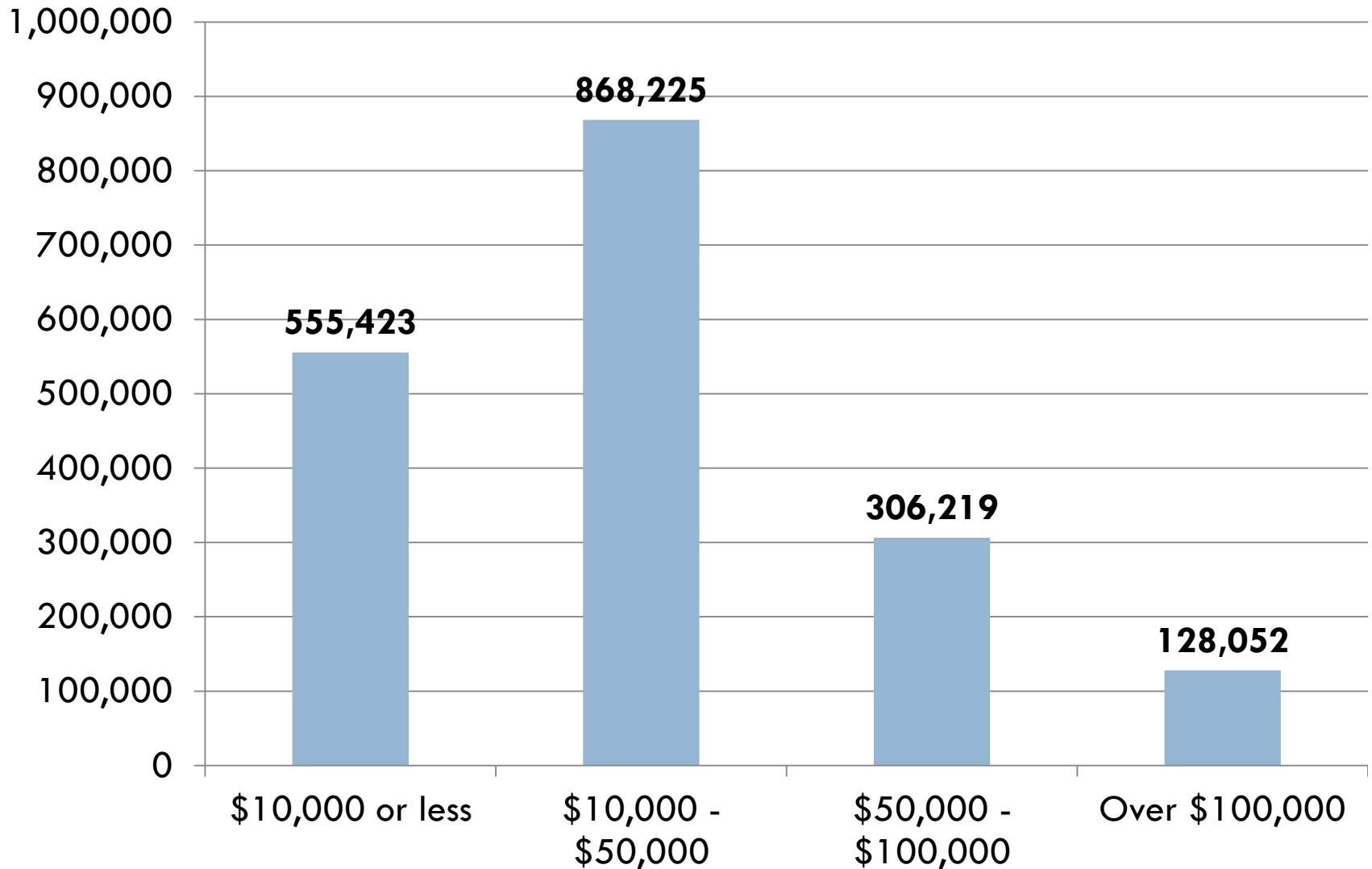
Fiscal Impact upon full implementation: -\$180.1 Million

Proposed Income Tax Rate Schedule

Current Rate Structure		Proposed Rate Structure	
AGI	Current Rate	AGI	Proposed Rate
\$0-\$3,000	2%	\$10,000 or less	4%
\$3,001-\$4,000	3%		
\$4,001-\$5,000	4%		
\$5,001-\$8,000	5%		
\$8,001-\$75,000	5.8%		
\$75,001 and over	6%	\$10,001 to \$50,000	5.5%
		\$50,001 to \$100,000	5.75%
		Over \$100,000	5.9%

Income Rate Reductions Will Benefit All, But Middle Income the Most

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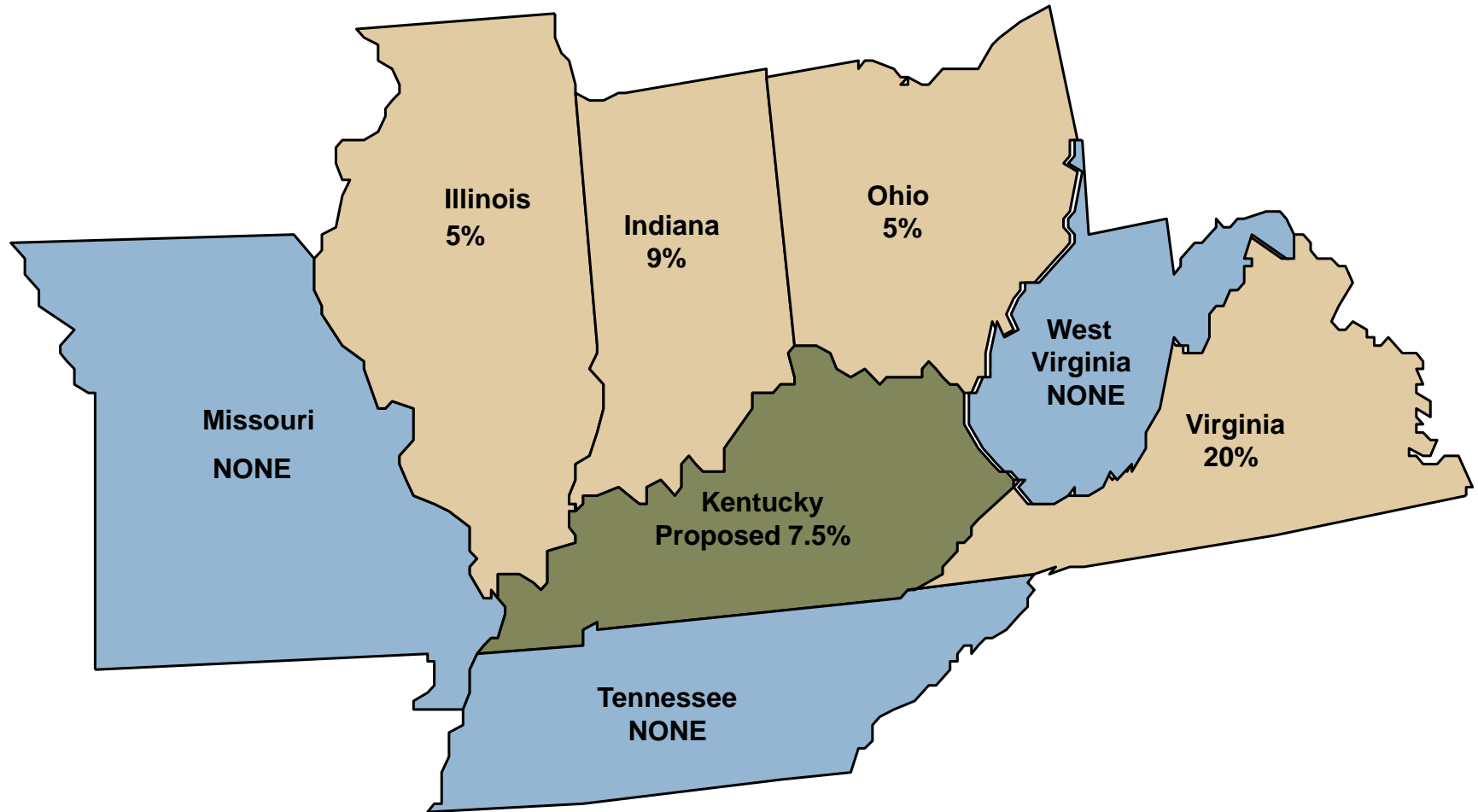
Enact a Refundable Earned Income Tax Credit (EITC) at 7.5% of the federal credit

- Approximately 424,000 Kentucky taxpayers would qualify
- Average credit would be \$171.50
- Economic benefits include:
 - Higher disposable income for lower-income Kentuckians
 - Increased incentive to join labor force
 - Increased sales for vendors who depend on in-state consumption for their primary sales base

Fiscal Impact upon full implementation: -\$72.75 Million

EITC in Surrounding States

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Lower the top corporate income tax rate from 6.0 percent to 5.9 percent

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- Will make Kentucky's rate the lowest compared to its surrounding states
- Economists recommend states have the same top corporate and individual rates to avoid arbitrary changes in business legal structures

State	Corporate Income Tax
Indiana	8.0%
Illinois	9.5%
Missouri	6.25%
Ohio	NA
Tennessee	6.5%
Virginia	6.0%
West Virginia	7.75%

Fiscal Impact upon full implementation: -\$6.4 Million

Phase in single factor apportionment, Change to incorporate market-based sourcing

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- Proposal would phase in single factor apportionment based solely on sales for corporation income tax, over a three-year period; and change the existing cost-of-performance based formula for apportioning sales to incorporate market-based sourcing for services.
- Currently, Kentucky determines its corporate income tax based on a three-factor formula of sales, property, and payroll. The current formula penalizes businesses that have made substantial investments in Kentucky plant operations and Kentucky Payroll
- Multi-state manufacturing companies in Kentucky would see significant savings; In particular, manufacturers and companies headquartered in KY will benefit
- Signals to prospective businesses that Kentucky is serious about increasing our industrial presence
- Proposal ensures that receipts from services are assigned based on the state of where the destination (market) of the service is located.
- 20 states currently use single factor apportionment. Only three neighboring states (IL, IN, MO) do.

Fiscal Impact upon full implementation: -\$154.5 Million

Create an angel investor tax credit for certain investments in small businesses

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- Kentucky investors in Kentucky startups can receive a non-refundable individual income tax credit of up to \$200,000
- The total amount of the credit would be capped at \$3 million
- 18 states have an angel investor program, including Indiana, Ohio and Virginia
- The credit is applied to 40% of the total investment, thus \$3 million in tax credits creates a total \$7.5 million in investments

Fiscal Impact upon full implementation: -\$3 Million

Expand the state's R&D Tax Credit to human capital

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- Currently, the R&D credit is linked to construction.
- This proposal expands the credit to human capital, such as salaries, or consultant research activity expenses
- The taxpayer may claim up to 5% of the total cost and the carry-forward is 10 years
- Indiana, Ohio, and Illinois have similar R&D credits

Fiscal Impact upon full implementation: -\$4 Million

Double the New Markets Tax Credit

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- New Markets Tax Credits incentivize the investment into communities within both urban and rural low-income areas to spur development and growth
- This proposal would increase the annual funding available by \$5 million to \$10 million
- This increase would leverage an additional \$62.5 million
- 12 projects have been funded with the existing credit, with investments of almost \$61 million

Fiscal Impact upon full implementation: -\$5 Million

Exempt inventory from state property tax

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- This proposal exempts certain kinds of inventory from the state's property tax including:

- Merchant's inventory,
- Manufactured finished goods, and
- Good stored in warehouse

- 52% of Kentucky's population lives in a border county

- Inventory and goods stored in warehouses are very mobile

Fiscal Impact upon full implementation: -\$7.2 Million

Eliminate selected negligible state property tax rates for tangible personal property, with an emphasis on classes of property subject to the “State Rate” only

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This proposal seeks to eliminate several taxes on certain classes of property that cost more to collect than they generate in funds. The current rates of 0.1% were set before the 1998 constitutional change allowed such taxes to be eliminated.

Some of these classes are:

- Manufacturer’s raw materials/ goods in process (5 cents per \$100)
- Motor Vehicles Held for sale dealers only (5 cents per \$100)
- Aircraft: non-commercial (1.5 cents per \$100)
- Watercraft: non-commercial (1.5 cents per \$100)
- Livestock & Farm Machinery (one-tenth of one cent per \$100)

Fiscal Impact upon full implementation: -\$5 Million

2) Help Kentucky's Signature Industries Thrive and Expand

Create an income tax credit for the bourbon industry

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- This credit must be reinvested in facilities and equipment
- The tax credit supports a signature industry while protecting local communities' and schools' property tax receipts
- Reinvestment will create improved competitiveness in the industry
- The Kentucky distilling industry is responsible for a total of 8,690 jobs in the state, with a total annual payroll of \$413 million. It has grown 120% since 1999

Fiscal Impact upon full implementation: -\$13.3 Million

Exempt the sales and use tax on certain equine-related products

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- This proposal extends exemptions that currently exist for other livestock to our signature equine industry
- Kentucky's signature horse industry has an economic impact of over \$3 billion to the commonwealth annually as well as supporting over 40,000 jobs. This is down significantly from the \$4 billion industry with 100,000 jobs the industry represented just a few years ago.
- This includes sales tax exemptions for hay, feed, feed additives, watering systems, seed, and fertilizer
- This measure will enhance the competitiveness of a signature industry that has struggled significantly in recent years.

Fiscal Impact upon full implementation: -\$14.8 Million

Exempt the sales tax on pharmaceuticals for food animals

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- Food animals included are cattle, pigs, hogs, sheep, goats and poultry
- This exemption not only helps farmers but will provide a large incentive for animal pharmaceutical networks to repatriate to Kentucky
- Half of all states currently exempt pharmaceuticals for livestock, including all of our border states.

Fiscal Impact upon full implementation: -\$4.8 Million

Lower the wholesale tax on beer, wine, and distilled spirits; repeal the distilled spirits case tax

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- This proposal would lower the current 11% wholesale tax on beer, wine and distilled spirits to 10% over a three year period
- Distilled spirits are the only alcohol subject to a case tax and this proposal repeals a tax that unfairly targets a single industry

Fiscal Impact upon full implementation: -\$16.1 Million

3) Create a Healthier Kentucky Workforce to Attract Jobs

Increase tobacco tax rates

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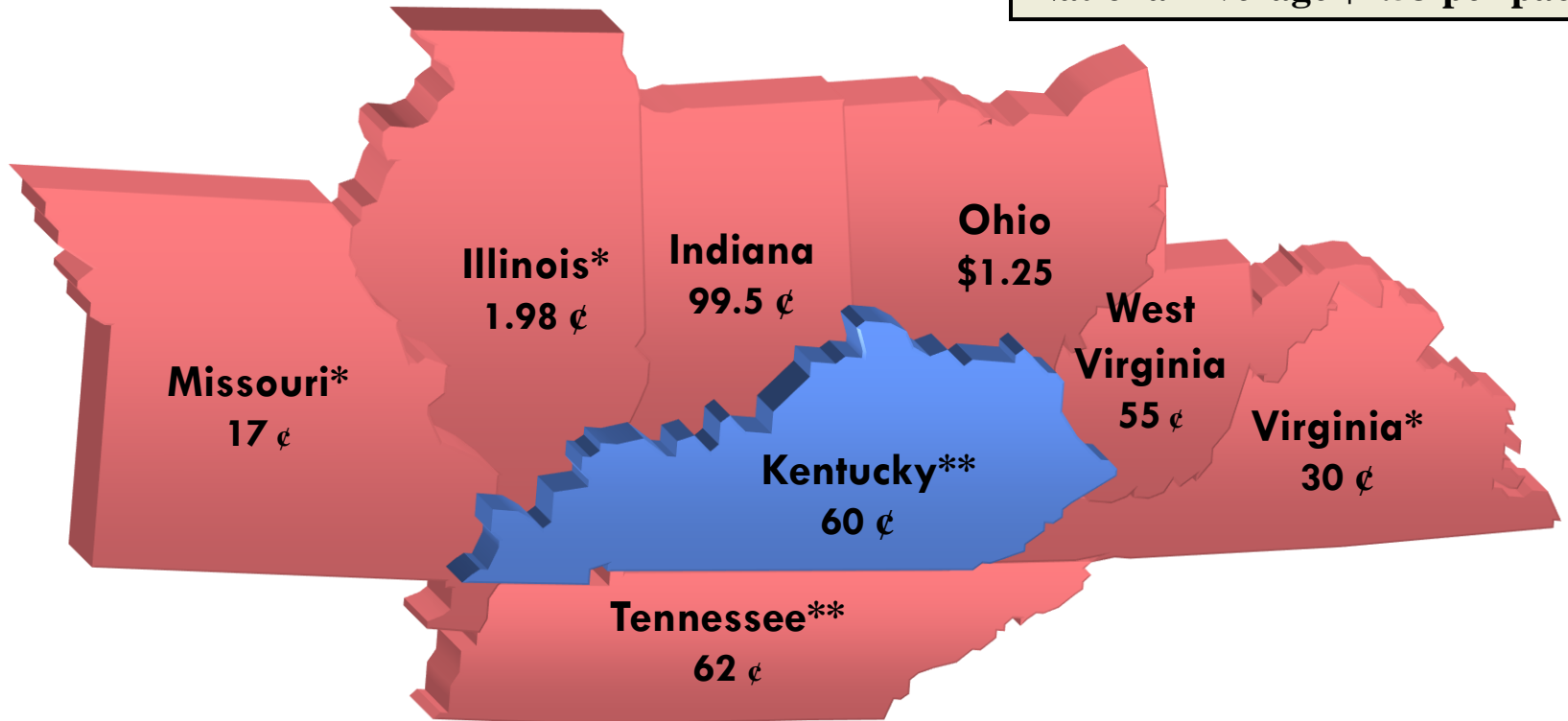
- Increases the tax on cigarettes from \$0.60 to \$1.00
- Increases the tax on other tobacco products from 15% to 25% of value
- Increases the tax on snuff and chew from 19¢ per tin or pouch to 32¢ per unit
- Introduces a tax on e-cigarettes at 20% of value, a new nicotine delivery system that has begun to garner a large share of the market, and presents new health challenges.
- This also includes a restoration of taxation of Cigarette Rolling Papers

Fiscal Impact upon full implementation: \$125.3 Million

State Excise Taxes on Cigarettes

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National Average \$1.53 per pack



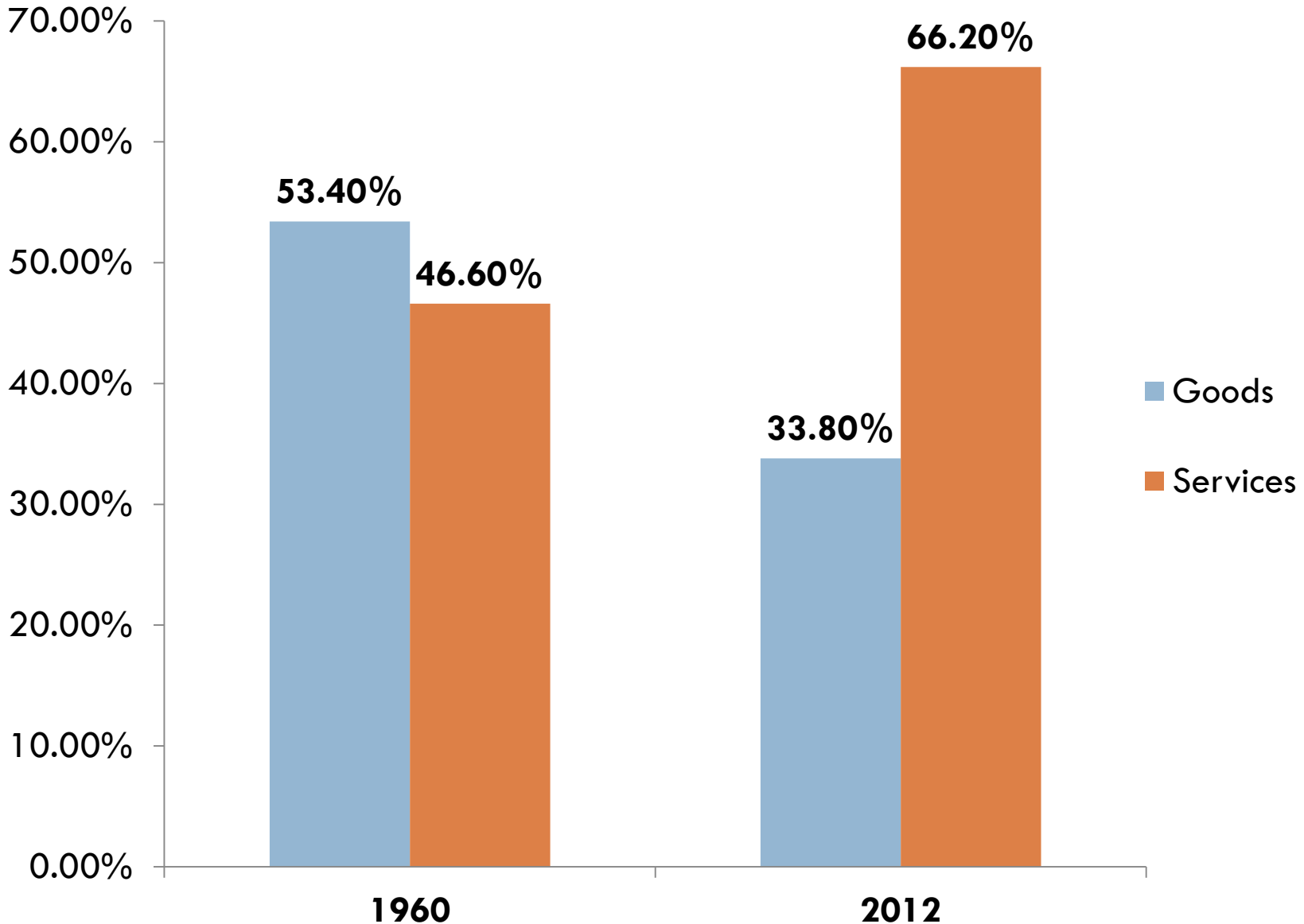
*Local governments also impose a tax.

** Dealers pay an additional enforcement and administrative fee of \$0.003 per pack

4) Modernize Code to Acknowledge Changes in the Economy & Technology

CHANGING ECONOMY - STAGNANT TAX CODE

Consumer Spending Patterns Have Changed



Principles for selecting services on which to apply the sales tax

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- Look to services that are not portable across state lines
- Look to services that are tied to a taxable tangible good and where the providers are already established with DOR
- Look to services already taxed by a significant number of other states, recognizing that every state taxes some services

Broaden the sales tax to include selected services

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Changes to the sales tax are necessary to prevent the further erosion of the tax base, to remove the structural deficit, and to bring Kentucky's tax code in line with its economy

This proposal includes recommendations to expand the sales tax to three broad areas of service:

- Installation, Maintenance and Repair of Taxable Personal Property
- Admissions and Recreational Activities
- Limited Commercial, Residential and Personal Services

Fiscal Impact upon full implementation: \$279.9 Million

Installation, Maintenance and Repair of Taxable Personal Property

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Examples	Full Implementation (millions)	Other States	Contiguous States
• Installation, repair and maintenance of all taxable machinery and equipment (personal and business)	\$54.45	24	OH, TN, WV
• Automotive repair services	\$45.15	25	OH, TN, WV
• Other repair services tied to consumer goods	\$17.09	24	OH, TN, WV
• Computer software/hardware installation and repair	\$16.50	23 if installed by seller, 18 if installed by 3rd party	3 if installed by seller, 3 if installed by 3rd party (OH, TN, WV)
• Labor and repair services on electronics	\$9.95	24	OH, TN, WV
Subtotal	\$143.14		

Admissions and Recreational Activities

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Kentucky currently applies the sales tax to the admissions fees of several non-participatory recreational activities, such as amusement park entry fees, art exhibits, concerts, cover charges at bars, fairgrounds, movie theatres, museums, nightclubs, sports arenas, state parks and street fairs.

Examples	Full Implementation (millions)	Other States	Contiguous States
• Fitness and recreational sports centers	\$9.24	22	MO, OH, TN, WV
• Golf courses and country clubs	\$8.25	23	MO, OH, TN, WV
• All other amusement and recreation industries	\$6.36	31 (cultural events), 37 (professional sporting events)	MO, TN, WV
• Overnight Trailer Campgrounds	\$5.80	29	IN, MO, TN, VA, WV
• Marina and boat dock slip rental and storage services	\$5.25	18	WV
Subtotal	\$34.90		

Limited Commercial, Residential and Personal Services

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Service Category	Full Implementation (millions)	Other States	Contiguous States
• Landscaping services, excluding lawncare	\$25.03	21	IN, OH, WV
• Janitorial services (including carpet, upholstery and window cleaning)	\$21.68	19	OH, WV
• Warranty Service Contracts for taxable property	\$21.61	33	IL, IN, OH, TN, VA, WV
• Industrial Launderers and Linen Supply	\$17.80	33	OH, TN, VA, WV
• Security systems services (except locksmiths)	\$11.20	18	OH, WV
• Pet care (except medical veterinary) services	\$2.64	18	TN, WV
• Tanning Salons	\$1.90	22	MO, OH, TN, WV
Subtotal	\$101.85		

Clarify that the sales tax is applicable to all prewritten software, regardless of method of delivery

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- This proposal will preserve Kentucky's existing tax base by clarifying that prewritten software accessed in the digital cloud is still subject to the sales tax.
- At least 14 states tax remote access to software, including IN, OH, WV

Fiscal Impact upon full implementation: \$5 Million

Apply sales tax and transient room taxes to the entire hotel accommodation price

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- The advent of online hotel room purchasing has led to an erosion of revenues to state and local governments
- This proposal makes sure that all amounts paid for hotel accommodations, including those charged by online travel companies, are included in the tax base
- This proposal updates our tax code to the changing method of delivery

Fiscal Impact upon full implementation: \$4.7 Million

5) Modernize Code to Acknowledge Changes in Competitor States

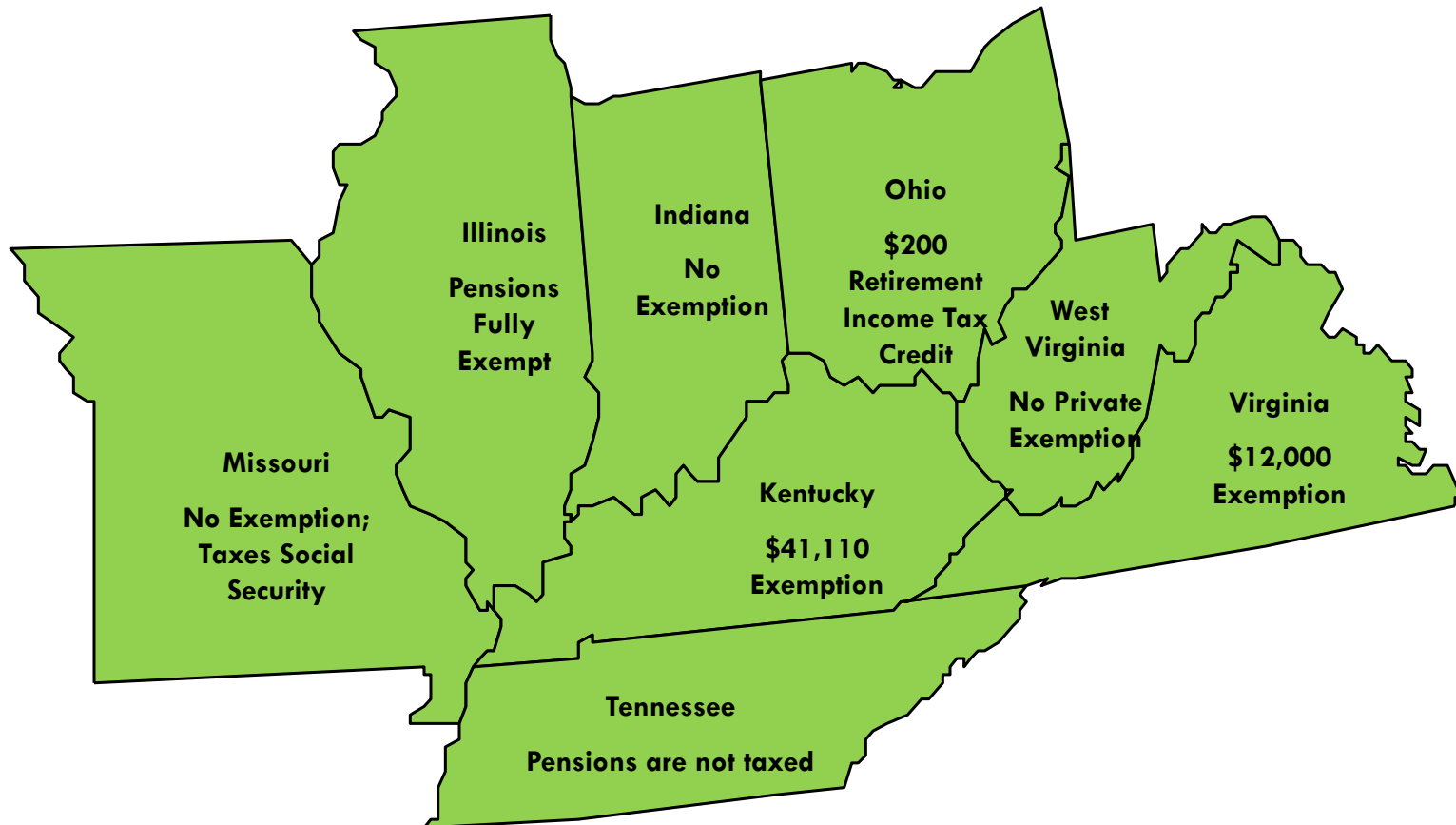
Reduce retirement income exclusion for taxpayers with a federal AGI over \$80,000 and phase it out for AGI of \$100,000

- Only 90,200 filers out of 1.8 million would be impacted by this proposal
- These filers have an average AGI of \$215,000
- Social Security benefits are not taxable and not affected by this proposal
- KY has an aging population that continues to use its services
- Economists suggested to the Blue Ribbon Commission taxation of retirement income as a way to improve elasticity and stabilize revenues

Fiscal Impact upon full implementation: \$176.3 Million

Pension Laws in Surrounding States

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Phase out the \$10 Individual Income Tax Credit

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- Created in 1960 at \$20 and lowered to \$10 in 2013 (takes effect in 2014), this tax credit is outdated and unnecessary.
- Tax relief for low-wage earners is currently provided by the Family Size tax credit
- Furthermore, the proposed EITC will also assist low-wage workers

Fiscal Impact upon full implementation: \$32.8 Million

Require the same income tax filing status for married couples at state level and federal level

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- Only 3 other states allow married couples to file separately on a combined return
- 20 states, including three of our border states, require “same as federal” status
- This provision will simplify the filing process
- 430,000 filers would be impacted by this proposal

Fiscal Impact upon full implementation: \$72.8 Million

Conclusions

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Competing for Every Job

**Revenue Increase Helps Relieve
the Structural Imbalance**

**A Modern Code that Grows with
the Modern Economy**